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Interim Work and Client Cooperation Contribute to Early Completion of the Audit

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INTRODUCTION

Early completion of the audit and prompt delivery of the audit report are worthwhile goals. Timely information contributes importantly to considered judgments. What are some of the reasons your clients want their financial statements certified as early as possible?

1. Early completion of the audit shortens the period following the close of the year during which the management may be uncertain, or possibly doubtful, as to the reasonableness of its financial statements.
2. Early completion of the audit gets your recommendations for changes in plans or methods of business operations to the management promptly so that it can secure the benefits of your recommendations without delay.
3. Timely information is appreciated by banks and credit grantors from whom the client may be seeking new financing, and thus the terms of such financing may be more favorable.
4. Early completion of the audit and release of the report improves shareholders' relations and public relations. It inspires confidence in the management. Shareholders, and others interested in business affairs, welcome information on operating results promptly after the close of the year.

In summary, if I may quote one of our favored expressions: Get it to them while it's hot, and get it to them before the information has become ancient history.

How, in this day of relatively large and complex business operations, is an early completion of the audit achieved? It is accomplished largely by extensive interim work, that is, by completing as much as possible of the audit before the year-end. And I contend further that interim work does contribute not only to an early completion of the audit, but that it produces other benefits to your client as well as to your own organization. For example:

Interim work will bring accounting and financial problems to your attention early enough to permit an orderly solution, and early consideration of these problems may prevent cumbersome year-end adjustments.

Interim work may disclose actions inadvertently taken or omitted by your client, and their adjustment before the close of the year might well save him embarrassment.

And is it not also a fact that we auditors learn more about the operations and the affairs of our clients and thus can furnish more meaningful advice, if we can spread the work, and if we do not have to perform all of it within the short time available during the busy season after December 31?

NATURAL BUSINESS YEAR

You heard me say after December 31, instead of after the close of the business year, and I shall digress briefly to talk about the so-called "natural business year", which is a favored subject among the certified public accountants in my country. When I discussed the subject of this paper with one of my German partners, he asked me what was responsible for the tendency of more and more American businesses to change their fiscal year from the calendar year to the natural business year. In Germany, it is the reverse; namely, there is a tendency to change from the natural business year to the calendar year. The question puzzled me and I did not realize its import until he also told me that the German businessman must file income tax returns on the calendar-year basis.

I am happy to be able to tell you that this is not the case in the United States. Except for a few special situations — for example, insurance companies — a United States corporation may file its Federal income and State income taxes on the fiscal year adopted by it for business purposes.

We recommend to our clients, therefore, adoption of a year-end date other than December 31 where this can reasonably be done. Selection of such a date should not, of course, be arbitrary. It should coincide with the close of the natural business year of the company. Such a date ordinarily is marked by a relatively low level of activity, both in production and sales, and often follows immediately after the completion of a period of heavy sales. Therefore, because inventories are

relatively low, less time is required to take and examine them. Also because the business is in its low season, the employees should be able to lend more assistance to the auditor at the year-end.

Considerable progress has been made in the United States during the past twenty years in adopting the natural business year as the fiscal year. In 1952, for example, 40.2 per cent of the active corporations filing Federal income tax returns reported on a noncalendar year basis. In 1942 this percentage was only 22.8, and in 1934 only 15.2. That is quite an increase within 18 years.

As you will realize, this tendency had a very beneficial effect upon our practices, in so far as it alleviated the heavy pressure during the merry days of the carnival time when one finds it so difficult to devote so much time to such somber activities as earning a living.

Undoubtedly, the tax situation deters many German companies from adopting the natural business year for general reporting purposes. However, considering the benefits, German Wirtschaftsprüfer may, if they have not already done so, wish to consider urging a change in the German tax laws.

INTERNAL CONTROL

Before going into the nature of interim work, I would like to touch briefly on internal control. That is a subject to which managements and public accountants in the United States have given a great deal of attention in recent years. The growth and expansion of corporations into complex and far-flung business concerns have made this necessary. This development has had an important impact on auditing.

Internal control, particularly as it relates to accounting matters, comprises the plan of organization and all of the methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, and encourage adherence to prescribed managerial policies. It is accomplished by proper segregation of duties and responsibilities to the extent that the activities of one person serve to check on the actions of another, and by an adequate system of interlocking authorization and recording procedures. These are the essential features of internal control from the standpoint of the auditor.

For the American auditor, the appraisal and evaluation of the effectiveness of a company's internal control is one of the most important jobs in determining audit procedures. In fact, the appraisal of in-

ternal control is the backbone of present-day American auditing. My firm, for example, has in use a printed internal-control questionnaire which is filled out by the accountant at the outset of each engagement. The questions in this questionnaire are designed to lead to conclusions indicating the areas in which internal control is good, weak, or lacking, and they are designed to point out the activities and records directly or indirectly affected.

In appraising the effectiveness of internal control, we also pay much attention to internal auditing, and at the outset of our examinations we review the work of the internal auditors. Many of the larger organizations in the United States have well-organized internal-audit departments.

Now, on the basis of these conclusions, we decide upon our audit program, and the volume of testing to be carried out. For example, if our study of the internal control shows the internal control to be weak or nonexistent, we examine transactions for about four or five months. And if necessary, the testing may be further extended until we are satisfied. At the other extreme, if we find the internal control to be very good, our testing will be kept at a minimum (perhaps a month or even less) — just enough of a test to substantiate our evaluation.

In discussing internal control, I should like to digress briefly and touch upon the subject of the auditor's responsibility. In the days when I was a junior auditor, and that goes back to the twenties, an auditor's prime responsibility was the detection of fraud. When you missed a defalcation, it was almost a sure bet that you lost one client. During the past twenty years, with the tremendous growth of corporate structures, this situation has changed somewhat.

Today the accountant's position with respect to responsibility for detecting defalcations has been fairly well codified, and I think it will be of interest to you to hear the statement issued on that matter by the American Institute. I quote:

"The ordinary examination incident to the issuance of an opinion respecting financial statements is not designed and cannot be relied upon to disclose defalcations and other similar irregularities, although their discovery frequently results. In a well-organized concern, reliance for the detection of such irregularities is placed principally upon the maintenance of an adequate system of accounting records with appropriate internal control. If an auditor were to attempt to discover defalcations and similar irregularities he would have to extend his

work to a point where its cost would be prohibitive. It is generally recognized that good internal control and surety bonds provide protection much more cheaply. On the basis of his examination by tests and checks, made in the light of his review and tests of the system of internal control, the auditor relies upon the integrity of the client's organization, unless circumstances are such as to arouse his suspicion, in which case he must extend his procedures to determine whether or not such suspicions are justified."

It is my personal opinion that it is far more sensible to have a meeting of minds between the independent public accountant and his client before an engagement is undertaken than to have a dispute arise afterward because of an undiscovered defalcation. At least one American accounting firm meets this problem squarely and with courage by informing their clients in writing before the work is started that it is not assuming responsibility for detection of defalcations and other similar irregularities.

NATURE OF INTERIM WORK

I have discussed internal control first, and before going into specific illustrations of interim work, because I have had the impression from talking with some of you that the existence of internal control in organizations is apparently not of the same importance to you as it is to us. In other words, in the case of excellent internal control, you may not necessarily reduce the scope of your examination as much as we would. Therefore, for a fair understanding of our procedures on interim work, which I will now go into, I ask you to keep that in mind.

Let us assume we are considering a recurring audit of a large industrial company, a manufacturer. The assumption of large size does not necessarily limit the general applicability of the suggestions offered. It does, I believe, lend comprehensiveness to the illustration. And let us assume that the client has established and maintained effective internal controls, and internal auditing has been effectively performed throughout the organization.

We divide the work between a preliminary audit and a final audit. In the preliminary audit we examine the accounts as of an interim date and the operations for the period to that interim date so that we are satisfied as to the propriety of the accounting principles applied and the integrity of the accounting records. The interim date should be a

month-end about two to three months before the close of the year. In the final work, that is, after the close of the year, we may therefore confine ourselves largely to reviewing important changes in affairs since the interim date and to performing various operations incidental to the annual closing and preparation of reports.

In the preliminary work, we review the accounting system and internal control, read the minutes of the board meetings, examine new contracts, leases, indentures, and other similar documents, and determine the tax problems. We review the internal auditors' working papers and discuss their findings with the internal auditor.

In the preliminary work, we review internal financial reports and other information on sales, cost of sales, and other operations. We review trends in volume of sales, cost of sales, and gross profit and investigate unusual fluctuations. We test sales accounts, cost-of-sales accounts, manufacturing-expense accounts, selling-expense accounts, and other operating accounts for correctness of classification, propriety of the entries, and the adequacy of underlying support.

In the preliminary work, we review important journal entries, test the vouchers supporting cash and other transactions, and examine property additions, to the extent we consider appropriate in the light of the existing internal controls.

And finally, we examine the details of most of the assets and some of the liabilities as of the interim date, and investigate the methods of making accruals and providing reserves.

We make every attempt to dispose of questionable items during the preliminary work, so that there will be no delay in closing at the end of the year.

Now, let us go into the final work.

During the final work, we examine the year-end adjustments, investigate material increases or decreases in balance-sheet accounts since the interim-examination date, and prepare the year-end report work. We do not repeat detailed operations which have already been attended to during preliminary work, except in instances where this is necessary because of deficiencies in internal control. We do, of course, examine any accounts which were opened or became active after the interim-examination date, so that the examination as a whole will be adequate.

In summary, provided the internal control is good, the interim work may be so extensive that the year-end work can be confined to:

(1) satisfying ourselves that there has been no material change in the conditions of internal control since the interim date, (2) investigating unusual transactions that have occurred since the interim date, (3) requesting confirmation of significant year-end balances, (4) obtaining representations from the client, (5) examining minutes of meetings of the board of directors and its important committees held since the interim date, (6) examining the important year-end analyses and schedules, such as bank reconcilements, (7) examining year-end adjustments, (8) and finally completing the preparation of the report.

There is no question that performing most of the audit as of an interim date, and later bringing the work up to the final closing date, involves a certain amount of duplication of effort. It has been my experience, however, that this duplication is usually negligible. I believe that the principal criterion for deciding on the steps that should be performed before the year-end is one of weighing the advantages of doing the work away from the pressures of year-end against the additional work required to bring it down to year-end. My firm found that the balance usually favors extensive interim work.

I have avoided getting into details as much as possible, and I am sure that is as you wish it. However, I trust that it may be appropriate to make a few special remarks on the procedures pertaining to several important areas of an audit, such as cash receipts and disbursements, payrolls, purchases and accounts payable, inventories, plant property, and sales and accounts receivable.

Cash Receipts and Disbursements

Because of their liquidity, cash balances are accounts which are ordinarily verified at the year-end. This is particularly true of the general cash accounts, that is, the regular checking accounts.

However, if the internal control is good, a great deal of interim work can be done on working-funds, payroll-cash funds, and petty-cash accounts. We believe that the usual procedures of reconciling may be carried out at an interim date. The year-end work is limited to reviewing the client's own reconcilements; agreeing the balances shown therein with the books; reviewing them for unusual items; and obtaining direct confirmations from banks for year-end balances, reconciling items, loans' collateral, and other such things. Incidentally, it may be of interest to you that all American banks return paid-checks to the companies with the bank statements.

Payrolls

As to payrolls, it should be possible to do practically all of the payroll audit work during the preliminary period. Such work could include observation of pay-offs, as we do on occasions, examination of approvals, tests of mathematical accuracy, examination of time records or clock-cards, etc. The work at the year-end may then be limited to an over-all review of the entries in the payroll accounts subsequent to the interim date to ascertain general reasonableness.

Purchases and Payables

The routine examination of purchase vouchers should be made during the interim period. In most cases, we also examine the general accounts payable at the interim date, and reconcile the trial balances of accounts payable with the control account and subsidiary records as of that date.

The work at the year-end may then be limited to a comparison of the totals of the client's trial balance of accounts payable with the related control balances, to eye-testing the additions, and to inquiring into questionable items. Material increases or decreases since the interim date should be investigated, and changes in the accounts-payable control since the interim examination date should be reviewed. It is also the practice to obtain written presentations from the client concerning liability matters at the year-end.

Inventories

It is general practice in the United States for the auditor to observe and test the taking of the physical inventory. Whether or not that can be done during the interim period depends, of course, upon the date selected by the client for inventory-taking. Again, practices vary considerably in this regard. Some companies may rely on cycle physical-inventory-taking, others may take it at the year-end. A substantial number of companies take inventories one or more months before the year-end. In such cases, the major part of the work, including the examination of valuations, extensions, and footings, can be completed before the close of the year.

If it is taken at the year-end, the auditor is quite limited in the things that he can do before that date. He can, however, in the interim, acquaint himself thoroughly with the procedure to be followed and can raise any questions he might have about the procedure before the count begins.

Plant Property

Preliminary work applied to property accounts can, because of the relative permanence of fixed assets, be as complete as for any other group of accounts. This work ordinarily includes tests of the data supporting property acquisitions and retirements, inspection of authorizations for building projects, and tests of depreciation provisions.

The work at the year-end can be limited to a review of entries in the control accounts and related reserve accounts, and to an examination of important transactions since the interim examination date.

Sales and Receivables

Tests of sales transactions can ordinarily be completed, or virtually so, before the year-end. Such tests comprise checking examination of sales invoices and returns and allowances, and scrutinizing them for apparent validity and regularity, and checking of sales records, etc. We also request customers to confirm their balances as of the interim examination date. As you may know, it is required audit procedure in the United States to select some of the balances for direct confirmation with customers. In view of the close relation of accounts receivable and cash balances, the confirmation requests are usually made for the day as of which the cash balances are reconciled. Incidentally, requesting confirmations and processing replies represents generally a fair portion of the total audit time.

If this work is done at the interim date, the year-end work can usually be limited to reviewing customers' trial balances, inquiring into questionable items, and investigating material increases and decreases.

CLIENTS' ASSISTANCE

I hope that I have presented to you a reasonably clear picture of how we do interim work. I should now like to touch briefly on the subject of client cooperation which undoubtedly is also an important factor contributing to early completion of the audit.

At the outset, I wish to make it clear that by client assistance, I do not have in mind that he should in any way assist the auditor in performing audit services. Manifestly, the external auditor should not put the client's employees in his place as an independent expert. He must not use the services of the employees to the extent that their judgment as to the reliability of records will be substituted for his own.

The area in which he can be of help, without diluting the auditor's independence, is principally in the performance of mechanical operations associated with an audit, or, if I may use a favored expression, free the auditor from too much pencil-pushing and so give him more time to think. For example:

To inform ourselves of the actions taken by stockholders, Board of Directors, and Executive Committee, we do not only read minutes of their meetings, but must make excerpts of pertinent matters for our working papers. Would it not save time if the client made copies of the minutes of such meetings for the auditors at the time they are typed by the secretaries?

In the performance of our examination, we do not only study internal reports and analyses prepared by the accounting department on sales, costs, expenses, etc., but again must make excerpts of pertinent matters for our working papers. Would it not save time if the client made copies of such reports for the auditor at the time they are typed so that they could be retained by him and used as a working paper? Of course, if that is contemplated, the auditor should early in the year inform the client of the material needed.

Further, in the performance of our work, we prepare many account analyses which either are not prepared by the client's accounting department in the regular course of business, or are prepared in a form which may not be readily usable for auditing. Examples of such papers are bank reconcilements, schedules of accounts and notes receivable showing age of balances, analyses of investments, of prepaid expenses, of deferred charges, of certain liabilities, of accruals, of reserves, and of certain important or unusual expense accounts. I believe that, in most cases, the mechanical preparation of such schedules does not in itself serve as an audit function. In fact, it is generally true that the real auditing function does not begin until the facts are presented in a manner which permits ready review. And I therefore suggest that the client should be encouraged to prepare such schedules wherever possible. Let me make this clear. I am not talking about analyses or schedules that serve no audit purpose. I am talking about essential analyses or schedules for which the mere mechanical process of preparation serves no audit purpose.

As a matter of fact, and this is digressing somewhat from the subject of client's assistance, it happens more often than not that unnecessary working papers are prepared by inexperienced accountants,

sometimes resulting in excessive fees. We have recently attempted, in our firm, to tackle this question by having a review made of all working papers at all our offices in the United States. To obtain a good and unbiased job, the reviews were made by partners who had no direct contact with the engagement. It was a considerable task, but the results were worthwhile.

If I were discussing the question of client's cooperation in America, I might mention that furnishing the auditor with comfortable quarters, adequate facilities, and messenger service will also contribute to the early completion of an audit. I will not mention it here, because I had the opportunity for three full years, back in the thirties, to serve our clients in Germany, and will always remember the extraordinary and characteristically German friendliness and courtesies with which I was received.

CONCLUSION

In conclusion, I reiterate, early completion of the audit and prompt delivery of the audit report are worthwhile goals, and can be accomplished by extensive interim work and with the cooperation of the client. The auditor is benefited and, what is more important, the client is benefited by it. As I said before, get it to them while it's hot, and get it to them before the information has become ancient history!